Order Code IB92069

CRS Issue Brief for Congress
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A Value-Added Tax Contrasted With a National Sales Tax

Updated April 20, 2006

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A Value-Added Tax Contrasted with a National Sales Tax

SUMMARY

President George W. Bush has stated that tax reform is one of his top priorities in the 109th Congress. Both a value-added tax (VAT) and a national sales tax (NST) have been proposed as replacement taxes for all or part of our current income tax system. In addition, there is congressional interest in using a consumption tax to finance national health care or reduce the budgetary deficit.

A firm's value added for a product is the increase in the value of that product caused by the application of the firm's factors of production. A VAT on a product would be levied at all stages of production of that product. A firm's net VAT liability is usually calculated by using the credit method. According to this method, a firm determines its gross tax liability by multiplying its sales by the VAT rate. Then the firm computes its net VAT liability by subtracting VAT paid on purchases from other firms from the firm's gross VAT liability.

The three types of VAT differ in their tax treatment of purchases of capital (plant and equipment). A consumption VAT treats a firm's purchases of plant and equipment the same way as any other purchase by a firm. All developed nations with VAT have the consumption type. The other two types of VATs are the income VAT and the gross product VAT. Under the income VAT, the VAT paid on the purchases of capital inputs is amortized (credited against the firm's VAT liability) over the expected lives of the capital inputs. Under the gross product VAT, no deduction for the VAT on purchases of capital inputs is allowed against the firm's VAT liability. An NST would be a federal consumption tax collected only at the retail level by vendors. Both a VAT and an NST are assumed to be ultimately paid by consumers. For calendar year 2004, a broad-based VAT or NST would have raised net revenue of approximately $70 billion for each 1% levied.

The operating differences between a consumption VAT and an NST have important policy implications. The administrative cost of a VAT would exceed that of an NST because a VAT would require more information to be reported and audited. An opportunity exists for an NST to be collected jointly with state sales taxes, but a federal VAT offers no readily available joint collection possibilities. A consumption VAT with the credit method more easily excludes inputs from double taxation than does an NST. A consumption VAT would be easier to enforce than an NST. It is in the self-interest of a firm to have accurate purchase invoices so that it can obtain full credit for prior VAT paid. Tax authorities can double check the accuracy of the VAT remitted by any firm because data are collected from producers at all levels of production. A VAT could have a broader tax base than an NST because a VAT is easier to enforce. A VAT could have a higher tax rate than an NST because a VAT is more difficult to evade. A VAT would require more time to implement than an NST because a VAT is more complicated, covers more firms, and is a new tax method. A VAT may be less visible to consumers than an NST. A VAT is levied at all stages of production, and policymakers have the option of not requiring the amount of VAT to be shown on retail sales receipts.

MOST RECENT DEVELOPMENTS

On Tuesday, May 9, 2006, the Subcommittee on Select Revenue Measures of the House Ways and Means Committee will hold a hearing on corporate tax reform. This will be one of a series of Committee hearings on the issue of federal tax reform.

BACKGROUND AND ANALYSIS

President George W. Bush has stated that tax reform is one of his top priorities in the 109th Congress. Both a value-added tax (VAT) and a national sales tax (NST) have been proposed as replacement taxes for part or all of our current income tax system. In addition, there is congressional interest in using a VAT or a NST to finance national health care. Both the VAT and the NST are taxes on the consumption of goods and services and are conceptually similar. Yet, these taxes also have significant differences. This issue brief discusses some of the potential policy implications associated with these differences.

Concept of a Value-Added Tax

The value added of a firm is the difference between a firm's sales and a firm's purchases from all other firms. In other words, a firm's value added is simply the amount of value that a firm contributes to a good or service by applying its factors of production (land, labor, capital, and entrepreneurial ability). A value-added tax would be a tax, levied at each stage of production, on a firm's net value added. The credit method is usually used to collect the VAT. Under the credit method, a firm would calculate the VAT on its sales. Next, a firm would compute its VAT liability by subtracting the VAT paid on its inputs from the VAT on its sales, and would then remit the difference to the federal government to cover its tax liability.

There are three types of VATs which differ in their tax treatment of purchases of capital inputs (plant and equipment). The consumption-type VAT treats capital purchases the same way as the purchase of any other input (i.e., it is equivalent to expensing). The other two types of VATs are the income VAT and the gross product VAT. Under the income VAT, the VAT paid on the purchases of capital inputs is amortized (credit against the firm's VAT liability) over the expected lives of the capital inputs. Under the gross product VAT, no deduction for the VAT on purchases of capital inputs is allowed against the firm's VAT liability. The consumption VAT is the only type of VAT that is used in developed nations and has been proposed for the United States; consequently, the consumption VAT is contrasted with the NST in this issue brief.

A National Sales Tax

A national sales tax (NST) would be a federal consumption tax collected only at the retail level by vendors. The NST would equal a set percentage of the retail price of taxable goods and services. Retail vendors would collect the NST and remit tax revenue to the federal government.

The retail price of a good or service equals the sum of value added at all stages of production. Consequently, a value-added tax and a national sales tax with the same tax rate and tax base would yield the same amount of revenue. The operating assumption of policymakers and economists is that both taxes are fully shifted forward onto consumers; that is, the price to the consumer increases by the (full) amount of the tax. For calendar year 2004, a broad-based VAT would have raised net revenue of approximately $70 billion for each 1% levied.

Policy Implications

The operating differences between a VAT and a NST have many important policy implications, including the following eight factors: administrative cost, joint tax collections, avoiding double taxation of intermediate goods and services, enforcement, broadness of tax base, maximum tax rate, time required to implement, and visibility.

Administrative Costs

Under a VAT, all firms would have to report tax information and collect taxes. Under a NST, firms without retail sales would not report or collect taxes. But the substantial majority of all firms would collect the NST since they have some retail sales. Under a VAT with a credit method of collection, each firm must keep invoices on all sales and purchases from other firms, and these invoices would be subject to audit by tax authorities. Hence, the value-added tax would require more information to be reported and audited than a national sales tax, and, consequently, a VAT could be expected to be more expensive to administer than a NST.

Joint Tax Collection

Since 45 states and the District of Columbia have general sales taxes, an opportunity exists for a NST to be collected jointly with state sales taxes. A federal VAT could not be jointly collected with state sales taxes. States could convert their sales taxes to a VAT with the federal tax base, but this is unlikely since it would require that the states establish an entirely new tax system. Consequently, no administrative costs saving would be expected from a VAT; therefore, the collection costs of a VAT can be expected to be higher than a NST.

Avoiding Double Taxation of Intermediate Goods and Services

Double taxation occurs if an input is taxed at the time of purchase and then a tax is levied on the same input again when it becomes part of the output of the firm. A consumption VAT, with the credit method of tax computation, easily excludes inputs from taxation. The exclusion of inputs from a NST would be more difficult. Usually, firms buying inputs would have to provide sellers with exemption certificates before making their purchases. At the state level, procedures to exempt input purchases from state retail sales taxes have worked imperfectly. It is therefore reasonable to expect that excluding inputs from taxation would be more difficult with a NST than with a VAT.

Enforcement

With a VAT, a firm would have a financial interest in ensuring that amounts of VAT paid on input purchases are accurately reported on its purchase invoices since the firm could receive credits against its VAT liability. In addition, the VAT would provide the tax authorities with an opportunity to cross-check the amount of VAT collected because data are gathered from producers at different stages of production. Some enforcement problems do exist with a VAT. For example, firms at different stages of production could collude to falsify invoices. But the NST lacks both the self-enforcing procedure and the cross-checking opportunity of the VAT. Hence, better compliance is expected from a VAT than with a NST.

Broadness of Tax Base

Because of the potential for better enforcement of a VAT, it may be possible to levy a VAT on more goods and services than a NST. This view is supported by the fact that VATs of European nations, on the average, are levied on more goods and services than most state sales taxes in the United States.

Maximum Tax Rate

Both the self-enforcing procedure and the cross-checking opportunity of a VAT would increase the probability of a tax evader being apprehended. Thus, for a given tax rate, a VAT is expected to have better voluntary compliance than a NST. In general, as a tax rate rises, the financial gains from tax evasion increase relative to the punishment if apprehended. Consequently, it is expected that as a consumption tax rate is increased, the level of tax evasion would rise. Since voluntary compliance with a VAT is expected to be better than with a NST, the tax rate for a VAT may be raised to a higher level than for a NST before a problem with tax evasion occurs.

Time Required to Implement

The VAT would take more time to implement than a NST. The VAT is more complicated and would cover more firms than a NST. Also, business executives are not familiar with this form of taxation, so the U.S. government would have to conduct an educational campaign.

Visibility

The value-added tax may be less visible to consumers than a national sales tax. Policymakers and economists assume that 100% of both the VAT and the NST are passed onto consumers. But the perceptions of many consumers may be different about a VAT. Many consumers may believe that a VAT tax would at least partially fall on firms because the VAT is collected at each stage of production. Since the NST is levied only at the retail level, consumers may more readily believe that they would pay the entire tax. Furthermore, policymakers have the option as to whether the amount of a VAT should be stated on retail sales receipts. The amount of a NST would be explicitly stated on sales receipts.

The lower visibility of the VAT relative to the NST may be either desirable or undesirable depending on one's political ideology. It can be argued that taxes should be visible so that the costs of taxation may be compared with the benefits of government spending. Conversely, it can be argued that people generally do not like the idea of paying taxes; consequently, to finance public sector responsibilities, it is better to have taxes seem as painless as possible.

Legislation

H.R. 15 (Dingell). National Health Insurance Act. Provides for a program of national health insurance. Imposes a five percent value-added tax (VAT) to finance health benefits. Revenue from the VAT would initially be deposited into the proposed National Health Care Trust Fund. Introduced January 4 2005; referred to the House Energy and Commerce Committee and the House Ways and Means Committee. On January 25, 2005; referred to Subcommittee on Health of the House Ways and Means Committee.

H.R. 25 (Linder). Fair Tax Act of 2005. To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States. Introduced January 4, 2005; referred to the Committee on Ways and Means.

H.R. 1040 (Burgess). Freedom Flat Tax Act. This bill would allow individuals to elect irrevocably to pay a flat tax as an alternative to our current income tax. In the first two years, the flat tax rate would be 19%, but in subsequent years the rate would decline to 17%. This bill would become effect in tax year 2006. Introduced March 2, 2005; referred to the Committee on Ways and Means.

H.R. 1601 (Fattah). Comprehensive Transform America Transaction Fee Act of 2005. This bill would require a study and comprehensive analytical report on transforming America by reforming the federal tax code through elimination of all federal taxes on individuals and corporations and replacing the federal tax code with a transaction fee-based system. Introduced April 13, 2005; referred to the Committee on Ways and Means.

H.R. 4707 (English). Simplified USA Tax Act of 2006. Replaces the individual income tax, the corporate income tax, and the estate and gift taxes with a border-adjustable business tax (subtraction-method VAT) and a progressive consumed-income tax. Individuals may utilize the equivalent of universal Roth IRAs to encourage savings. Introduced February 8, 2006; referred to the Committee on Ways and Means.

H.R. 4725 (Goodlatte). Tax Code Termination Act. On December 31, 2009, this act terminates the tax code except for Social Security taxes and Railroad Retirement taxes. States that "Congress ... declares that any new federal tax system should be simple and fair ...." Establishes a new federal tax, which has a low tax rate and eliminates the bias against savings and investment. Requires that the new federal tax system be approved by Congress not later than July 4, 2009. Introduced February 8, 2006; referred to the House Committee on Ways and Means.

S. 25 (Chambliss). Fair Tax Act of 2005. To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the states. Introduced January 24, 2005; referred to the Senate Finance Committee.

S. 812 (Specter). Flat Tax Act of 2005. Imposes a 20% flat rate consumption tax (modified VAT) as a replacement of the individual income tax, the corporate income tax, and the estate and gift tax. This flat tax would consist of two components: a wage tax and a cash-flow tax on businesses. Introduced April 15, 2005; referred to the Senate Finance Committee.

S. 1099(Shelby). The Tax Simplification Act of 2005. Repeals the corporate income tax, the individual income tax, and the estate and gift tax, and replaces these taxes with a flat rate consumption tax of 19% for the first two years (declining to 17% in the third year). Introduced May 23, 2005; referred to the Committee on Finance.

S. 1921 (DeMint). The Savings for Working Families Act of 2005. Replaces the current individual income tax, the corporate income tax, and the estate and gift taxes with an 8.4% national retail sales tax and an 8.4% subtraction-method value-added tax (referred to as a business tax). Introduced October 26, 2005; referred to the Committee on Finance.

S. 1927 (Wyden). Fair Flat Tax Act of 2005. Proposes to make the federal income tax system simpler, fairer, and more fiscally responsible. Introduced October 27, 2005; referred to the Committee on Finance.

S. 2122 (Isakson). Date Certain Tax Code Replacement Act. Establishes within the legislative branch a National Commission on Tax Reform and Simplification that shall review and submit to Congress a report on (1) the present structure and provisions of the Internal Revenue Code; (2) whether tax systems imposed under the laws of other countries could provide more efficient and fair methods of funding the revenue requirements of the government; (3) whether the present income tax system should be replaced with a flat tax, a national sales tax , or any other specified tax system; (4) whether the Internal Revenue Code can be simplified, absent wholesale restructuring or replacement; and (5) the transition costs (including the length of time recommended for a smooth transition) associated with any changes to the present federal tax system. Authorizes appropriations for the Commission.

Any new federal tax system would require approval by Congress no later than July 4, 2008. If a new federal tax system is not approved by July 4, 2008, then Congress would be required to vote to reauthorize the Internal Revenue Code of 1986. Introduced December 16, 2005; referred to the Senate Committee on Finance.

For Additional Reading

CRS Products

CRS Issue Brief IB95060, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, by James M. Bickley.

CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Gregg A. Esenwein and Jane G. Gravelle.

CRS Report 98-529, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, by James M. Bickley.

CRS Report RL30351, *Consumption Taxes and the Level and Composition of Saving*, by Steven Maguire.

CRS Report RL33025, *Fundamental Tax Reform: Options for the Mortgage Interest Deduction*, by Pamela J. Jackson.

CRS Report RL32266, *Transaction Tax: General Overview*, by Maxim Shvedov.

CRS Issue Brief IB91078, *Value-Added Tax as a New Revenue Source*, by James M. Bickley.

CRS Report RS22367, *Federal Tax Reform and Its Potential Effects on Saving*, by Gregg A. Esenwein.

CRS Report RS22242, *Tax Reform and the Goal of Revenue Neutrality*, by Gregg A. Esenwein. crsphpgw